SCS Agency
Franchise Tax Board

ANALYSIS OF AMENDED BILL

Author: Assembly Rev. & Tax Comm. Analyst: Jeani Brent Bill Number: AB 1040

Related Bills: See Legislative History Telephone: 845-3410 Amended Date: 03/31/97

Attorney: Doug Bramhall Sponsor: Franchise Tax Board

SUBJECT: Court Ordered Debt/Financial Corps Offsets/Corps Defined/Banks/Information Reporting/Economic Nexus/Remove Credit Election/Misc. Technical Amendments

SUMMARY

This bill, sponsored by the Franchise Tax Board, would do the following:

1. Allow the department to receive federal information return data regarding the discharge or cancellation of indebtedness. (Page 3, Information Reporting/Discharges.)

2. Create a reporting requirement for payers of interest or dividends from bonds issued by another state that are exempt from federal taxation. (Page 5, Information Reporting/Bond Interest.)

3. Permit wage omissions identified through the information exchange with the Employment Development Department (EDD) to be assessed pursuant to mathematical error procedures and allow the right of protest and appeal for these deficiencies. (Page 8, Wage Discrepancies.)

4. Allow the state or county to refer to the department for collection court-ordered amounts that are associated with court-ordered fines, penalties, forfeitures or restitution orders. This provision also would allow restitution orders due a victim to be referred to the department for collection, but only if (1) the account is referred by a governmental entity that has the authority to collect on behalf of the victim, and (2) the authorized governmental entity voluntarily agrees to refer the debt to the department for collection and agrees to other administrative duties relating to account referrals and collection distributions. (Page 10, Court-Ordered Debt Collection.)

5. Specifically include in the definition of doing business the holding by a corporation of a partnership interest in a partnership that is doing business in this state, but would not subject the corporate partner to the minimum franchise tax. (Page 12, Change In Doing Business Definition.)

6. Modify the definition of "corporation" to include banks, unless specifically provided otherwise; provide specific language to exempt banks from existing provisions of the Administration of Franchise and Income Tax Laws and Regulations (AFITL) and the Bank and Corporation Tax Law (B&CTL) for which intentional differences between the treatment of corporations and banks is

DEPARTMENTS THAT MAY BE AFFECTED:

____ STATE MANDATE ____ GOVERNOR'S APPOINTMENT

Department Director Position:	Agency Secretary Position:	**GOVERNOR'S OFFICE USE**
____ S ____ O	____ S ____ O	
____ SA ____ OUA	____ SA ____ OUA	Position Approved ____
____ N ____ NP	____ N ____ NP	Position Disapproved ____
____ NA ____ NAR	____ NA ____ NAR	Position Noted ____
_____ PENDING	DEFER TO _____	
Department Director Date	Agency Secretary Date	By: Date:
Gerald Goldberg 4/28/97		

clear, such as the corporation income tax; and replace the phrase "bank or corporation" with the term "corporation" throughout the B&CTL and the AFITL. The department's policy of not applying Section 24411 to banks would be reversed, allowing a foreign bank to pay exempt dividends to a domestic water's-edge taxpayer. (Page 13, Corporate Definition To Include Banks.)

7. Remove the election provision from the Los Angeles Revitalization Zone (LARZ) sales or use tax credit, the Local Agency Military Base Recovery Area (LAMBRA) sales or use tax credit and the LAMBRA hiring and replace it with a provision limiting the taxpayer to one credit. (Page 16, Remove Credit Elections.)

8. Amend Chapter 952 of Statutes of 1996, which enacted SB 715, to reflect that its provisions apply to taxable or income years beginning on or after January 1, 1997. (Page 18, Operative Date.)

9. Repeal sections referring to offset provisions for personal property taxes or license fees that are obsolete, and delete references to those sections contained in other sections (B&CTL). (Page 19, Financial Corporation Offset.)

10. Delete an obsolete reference that requires all apportioning taxpayers to maintain specified information. (Page 20, Reference Correction.)

11. Change Section 19340 of the AFITL to reflect that when an overpayment is credited against any amount due, any interest on that overpayment also will be credited against any amount due. This provision also would include a reference to "this part," which is the AFITL. (Page 21, Interest On Overpayment.)

12. Correct a reference to Section 19276 of the AFITL contained in the Business and Professions Code and the Insurance Code to reflect that section's renumbering. (Page 22, Reference Correction.)

13. Delete an unnecessary and redundant reference to R&TC Section 23097. (Page 22, Redundant Reference.)

IMPLEMENTATION CONSIDERATIONS

Unless otherwise specified, implementation of the provisions of this bill would occur during the department's normal annual system update.

DEPARTMENTAL COSTS

Unless otherwise specified, the provisions of this bill would not impact the departments costs.

POSITION

Support.

The Franchise Tax Board voted at its October 28, 1996, meeting to sponsor legislation as contained in this bill.

SUMMARY OF TAX REVENUE EFFECT

The following table reflects the estimated impacts of the various provisions of this bill:

Estimated Revenue Impact of AB 1040 As Amended March 31, 1997	
1. Information Reporting/ Discharges	Possible acceleration of revenue collections
2. Information Reporting/Bond Interest	Gains of $5 to $11 million annually when fully implemented
3. Wage Discrepancies	No Impact
4. Court-Ordered Debt Collection	No Impact
5. Change In Doing Business Definition	Minor gains, less than $500,000 annually
6. Corporate Definition to Include Banks	$1 million to $2 million loss annually
7. Remove Credit Elections	No Impact
8. Operative Date	No Impact
9. Financial Corporation Offset (Technical Change)	No Impact
10.Reference Correction	No Impact
11.Interest on Overpayment (Technical Change)	No Impact
12.Reference Correction	No Impact
13.Redundant Reference	No Impact
Total	Gains of approximately $4 to $9 million annually

This analysis does not consider the possible changes in employment, personal income, or gross state product that could result from this measure.

1. INFORMATION REPORTING/DISCHARGES

EFFECTIVE DATE

This provision would become effective on or after January 1, 1998, and operative for returns required to be filed on or after January 1, 1998, for discharges made beginning on or after January 1, 1997.

BACKGROUND

For federal and state tax purposes, gross income generally includes income realized from the discharge or cancellation of indebtedness (COD). Income is realized to the extent that a debt is canceled or forgiven. Included in the meaning of a debt is any indebtedness for which a taxpayer is liable or any debt that attaches to property held by the taxpayer. A restructured debt resulting in a reduction of the debt amount is considered a discharge of indebtedness to the extent of the reduction.

For federal or state purposes, bankrupt or insolvent taxpayers may exclude COD income from gross income. However, the amount excluded must reduce the taxpayer's tax attributes, such as loss or credit carryovers or basis in assets. The amount of COD income excluded cannot exceed the amount of the adjusted tax attributes of the taxpayer. Thus, the amount excluded, in some cases, would be included in income in later years through reduced deductions or a larger gain on the disposition of an asset.

SPECIFIC FINDINGS

As a result of the federal Revenue Reconciliation Act of 1993, **federal law** requires that the cancellation of indebtedness of $600 or more by banks and corporations and certain other financial entities be reported to the Internal Revenue Service (IRS) on an information return (Form 1099C). The information return must include the name, address and taxpayer identification number of each person whose indebtedness was discharged during the calendar year, the date of the discharge and the amount discharged. The financial entity also must provide a written statement (on or before January 31 of the year following the calendar year for which the return was made) to each person on whom it has filed an information return, providing the name and address of the entity and the information required to be shown on the return with respect to that person.

Federal law requires financial entities filing 250 or more information returns to transmit tax information via magnetic media to the IRS. Persons filing less than 250 information returns may report via magnetic media or submit the information returns on paper.

Current state law provides that in specified instances the department may require a copy of the federal information return be filed with the department if a federal information return was required. However, information returns related to the discharge or cancellation of indebtedness are not specified.

Although state law requires that the discharge or cancellation of indebtedness be included in gross income, it does not require information reporting relating to the discharge or cancellation of indebtedness.

This provision would amend R&TC Section 18645 to require the filing of a copy of the federal information return relating to the discharge or cancellation of indebtedness.

Policy Considerations

While many taxpayers may not initially realize that relief from a debt is taxable income, receipt of the information return would make taxpayers aware of their federal obligations. This provision would allow the department to verify that taxpayers are appropriately including this information for state tax purposes. However, since California returns begin with federal adjusted gross income, any COD should be included on a California return if included in federal income.

TAX REVENUE DISCUSSION

Any collection revenue this provision may generate would depend on the extent to which taxes owed, due to discharges of indebtedness, would not have otherwise been assessed and collected through federal audit report information and information reporting currently available to the department. To the extent the department relies less on federal audit adjustments as a result of this provision, revenue collections could be accelerated.

These potential enhancements in revenue (i.e., new revenue and accelerated collections) are speculative and may not be significant since the majority of taxpayers most likely report discharges voluntarily on federal and state tax returns due to the federal information reporting requirement.

2. INFORMATION REPORTING/BOND INTEREST

EFFECTIVE DATE

This provision would apply to information returns required to be filed after January 1, 1998, for taxable or income years beginning on or after January 1, 1997.

BACKGROUND

Taxpayers acquire state or local municipal bonds primarily from two sources: brokerage houses or mutual funds. The brokerage houses and mutual funds generally purchase these bonds from the state or local government agency issuing the bonds and then act as conduits, selling the bonds or shares in the mutual funds to investors. Under such an arrangement, the state or local government agency issuing the bonds is not aware of the identity of the ultimate purchaser of the bonds; only the brokerage house or mutual fund has information regarding the owner of the bond. Interest earned on bonds is paid by the issuing state or local government agency to the brokerage house or mutual fund. The brokerage house as nominee has responsibility to pay earned to the investor. The mutual fund pays dividends to its shareholders. To the extent authorized by law, mutual funds are permitted to pay interest dividends that are exempt from income tax by the federal government or the state issuing the bonds. The information maintained by the brokerage house or mutual fund is the information discussed in this analysis.

SPECIFIC FINDINGS

Existing federal law requires all interest and dividend income to be included in gross income unless specifically excluded. Federal law generally provides for the exclusion from gross income of interest income derived from state, county or municipal bonds. Federal law also excludes interest from U.S. Savings Bonds in limited circumstances. Under federal law, a brokerage firm may act as a nominee for a taxpayer by purchasing a bond, receiving the interest and paying that interest, less expenses, to the taxpayer (investor).

Existing federal law also excludes from income “exempt-interest dividends.” Exempt-interest dividends equal interest paid by any state or local government to a mutual fund, which, less charges and expenses, is subsequently paid to an investor. Exempt-interest dividends are tax-exempt for federal purposes when paid to an investor provided that at the close of each quarter of the mutual fund’s taxable year, at least 50% of the value of the total assets of the regulated investment company (RIC) consists of state or local obligations exempt from federal tax.

Existing federal law requires that a person paying $10 or more in interest or dividends to any other person during a calendar year report payment of that interest to the Internal Revenue Service (IRS), unless otherwise provided. This requirement does not apply to interest paid by a state or local government on state or local bonds.

Exempt interest dividends paid by mutual funds and interest earned on bonds issued by a state received and later paid by nominees are exempt from federal

taxation and may be exempt from taxation by the issuing state. Mutual funds and nominees are not required to report to the IRS the payment of exempt interest dividends or interest that is exempt from federal taxation.

Existing state law requires all interest and dividend income to be included in gross income for tax purposes, unless the interest is specifically exempt from tax. Interest on bonds issued by California state and local governments and interest on bonds issued by the federal government are exempt from California tax. Interest income earned on bonds issued by another state or state's municipality is taxable for California residents and corporations doing business in California.

Existing state law provides that entities required to file an information return with the IRS for the payment of interest or dividends also must report that information to the department. Under state law, certain penalties may be assessed if an entity fails to provide an information return specifying the amount of interest paid. Entities not required to file an information return for the payment of interest or dividends exempt from tax under federal law are not required to file a state information return.

Because there is no federal reporting requirement, payers of interest and exempt interest dividends from bonds issued by another state are not required to report these amounts to California even though includible in California gross income. With no federal or California reporting requirement for payers of this interest or exempt interest dividends, the department has no means of verifying the amounts of interest income received by California taxpayers from bonds of another state or its municipalities.

Studies conducted by the department regarding reporting of interest income from other states found a noncompliance rate between 40% and 50% for taxpayers receiving interest and exempt interest dividends from other states' federally tax-exempt, municipal bonds. New York has an ongoing program (which began in the late 1980s) and has found similar levels of noncompliance.

This provision would create a reporting requirement for payers of interest or dividends from bonds issued by another state that are exempt from federal taxation.

Policy Consideration

This provision would provide information to allow the state to collect additional revenue without increasing taxes and to verify compliance with state law regarding taxable bond interest income, thereby increasing the efficiency of the tax system.

Implementation

Implementation of this provision would require establishing a program to inform brokerage and mutual fund firms of the new reporting requirement, incorporating new information returns into the department's existing processes and establishing a program to use the returns in the department's audit and filing enforcement programs to identify noncompliance.

Department staff has been working with representatives of the securities industries to assure ease of compliance and to make the California program compatible with existing filing requirements in New York.

Fiscal Impact

Departmental Costs

Initial Costs:

This proposal would be implemented in stages. If the proposal was enacted by September 1997, first stage costs would be incurred during the 1997/98 fiscal year. The first stage would encompass computer programming, the development of a database to receive information from brokers (Brokers would begin providing 1997 tax year information by June 1, 1998, with a possible extension if necessary), and the purchase of securities number listings. The list would be used to determine the universe of California taxpayers receiving other states' exempt interest or exempt interest dividend income. First stage costs are expected to be $54,000.

Assuming enactment by September, 1997, the first year implementation is expected to cost $400,000 in 1998/99 to process 1997 returns by comparing information received from brokers against the return information provided.

Second year (1999/2000 fiscal year) and ongoing costs are expected to be $853,000.

Tax Revenue Discussion

The first year estimate reflects a phase-in of the program. Full implementation would occur by the second year. Potential revenue gains reflect both audit adjustments and improved self-compliance. As proposed, payors would begin reporting information for the 1997 taxable year by mid-1998.

The revenue impact of this bill would depend on (1) the extent payers comply with the proposed reporting requirements, (2) the amount of unreported non-California state or municipal bond interest and/or dividend income captured in audit, and (3) the impact of information reporting on improved self-compliance.

The estimate was determined by assuming that a departmental compliance program would experience results comparable to that of an existing program in New York. New York's program suggests a rather high level of noncompliance with respect to taxpayers reporting interest and/or dividend income from investment in bonds issued by states and municipalities other than its own. That state's program generated revenue gains of roughly $7 million for the 1992 taxable year. Information is not available on the impact for improved self-compliance.

To more accurately reflect potential results of California's program, several adjustments were made to the results experienced by New York. Specifically, adjustments were made for the following differentials between New York and California: (1) relative amounts of interest and dividend income reported on tax returns, (2) relative probabilities of other state bond investments, and (3) marginal tax rates of municipal bond investors. An additional adjustment was made for the differential in municipal bond interest rates between the year of data and projection years. Estimated gains at the 1992 level were grown to projection year levels by either actual or forecasted growth rates in interest income as furnished by the Department of Finance.

3. WAGE DISCREPANCIES

EFFECTIVE DATE

This bill would become operative on January 1, 1998, and would apply to returns filed on or after that date.

LEGISLATIVE HISTORY

AB 3086 (Stats. 1994, Ch. 1049).

BACKGROUND

AB 3086 (Stats. 1994, Ch. 1049) was enacted to streamline the reporting process for California employers and to improve tax compliance. Upon full implementation of AB 3086, wage and withholding information will be sent to the Franchise Tax Board (FTB) from EDD within 24 hours of processing by EDD. The accelerated receipt of this data will improve taxpayer compliance by enabling FTB to detect discrepancies in the amount of wages reported and the amount of withholding claimed for personal income taxpayers. Thus, FTB will possess the capability to identify and correct wage and withholding discrepancies and to notify taxpayers of any discrepancy at the time their tax returns are processed.

SPECIFIC FINDINGS

Currently, FTB adjusts the amount of tax reported on a tax return by using a Proposed Assessment (PA) or a Return Information Notice (RIN).

PAs (deficiency assessments) are issued to increase the amount of tax reported on the return to an amount that is determined to be correct pursuant to an **audit.** The following rights are provided in the R&TC to taxpayers when deficiency assessments are issued:

- The right to a notice prior to assessment (R&TC Section 19033).
- The right to protest a proposed assessment (R&TC Section 19041).
- The right to appeal a disputed assessment to the Board of Equalization (R&TC Section 19045).

Since PAs are issued after the due date of the return, the taxpayer is subject to interest charges from the due date of the return to the date of payment.

Exising law allows for the issuance of RINs when mathematical errors or omissions are discovered while the return is processed (return validation). RINs are not deficiency assessments and protest and appeal rights are not provided to the taxpayer for these notices. Since RINs are issued during the return validation process, no interest accrues for refund returns (because the tax is timely paid) and interest charges are minimized in the case of remit returns.

Although the R&TC does not define the term “mathematical error,” Internal Revenue Code (IRC) Section 6213(g)(2) defines the term mathematical or clerical error to include:

- an error in addition, subtraction, multiplication or division shown on any return;

- an incorrect use of any table provided by the IRS with respect to any return if such incorrect use is apparent from the existence of other information on the return;
- an entry on a return of an item which is inconsistent with another entry of the same or another item on such return;
- an omission of information which is required to be supplied on the return to substantiate an entry on the return; and
- an entry on a return of a deduction or credit in an amount which exceeds a statutory limit imposed by certain federal laws if such limit is expressed as a specified monetary amount or as a percentage ratio or fraction and if the items entering into the application of such limit appear on such return.

The common denominator among these errors is that no additional data, extraneous to that shown on a return, is necessary to determine the existence of a mathematical or clerical error. Mathematical errors are discernible from information shown on the return, or the omission of information required to be shown on the return.

Long-standing practice has been to use the federal definition of mathematical error for determining when to issue RINs rather than PAs.

Wage discrepancies discernible from the information contained in the return meet the definition of a mathematical error and may be adjusted via a RIN during the return validation process. In addition, R&TC Section 19054 provides that errors and discrepancies in the amount of withholding claimed may be adjusted pursuant to mathematical error procedures (RIN).

Wage discrepancies that are not discernible from the information contained in the return are adjusted via a NPA upon an audit determination.

Existing law allows FTB to deny a credit or refund of the renter's credit[1] using mathematical error procedures except that the taxpayer has the right of protest and appeal if he does not agree with the notice.

This provision would add a section to the R&TC to permit wage omissions identified through the information exchange with EDD, from a source of wage information not identified on the tax return (e.g., omitted W-2), to be assessed pursuant to mathematical error procedures. This bill also would allow the right of protest and appeal for these deficiencies.

Policy Considerations

Allowing FTB to adjust wage and withholding discrepancies using the mathematical error procedure while providing the taxpayer protest and appeal rights would improve taxpayer service and reduce departmental costs.

Implementation Considerations

This proposal would be implemented during the department's normal annual system update.

FISCAL IMPACT

Departmental Costs

[1] The Renter's Credit is suspended for taxable years beginning on or after January 1, 1995, through January 1, 1997.

The estimated cost-savings associated with this bill would be in the range of $183,000 to $366,000, depending on the type of adjustments issued (i.e., RIN or NPA) from the EDD information. If 50% of the adjustments are assessed by RIN instead of PA, the cost-savings would be $183,000. If 100% of the adjustments are assessed by RIN, the cost-savings would be $366,000. This cost-savings is based on estimated costs to issue 50,892 PAs of $505,000 reduced by $139,000, the estimated costs to issue the same number of RINs with protest rights.

4. COURT-ORDERED DEBT COLLECTION

EFFECTIVE DATE

This provision would be operative for referrals made on or after January 1, 1998.

LEGISLATIVE HISTORY

AB 3343 (Stats. 94, Ch. 1242); SB 850 (Stats. 96, Ch. 705).

PROGRAM HISTORY/BACKGROUND

Legislation Creating the Court-Ordered Debt Collection Program

AB 3343 (Stats. 94, Ch. 1242) authorizes counties or the state to refer to the department for collection "fines, state or local penalties, forfeitures, restitution fines, or restitution orders" imposed by a court and due a county or the state. This collection program is a pilot program beginning January 1, 1995, and expiring January 1, 1999, unless otherwise extended.

AB 3343 was sponsored to enhance collection for the State Restitution Fund. The primary funding source for the State Restitution Fund is the state penalty assessment. Considering the department's success in collecting child support, the author and sponsor (Family Services Council of California) anticipated that the department would experience similar collection success for the State Restitution Fund. During the legislative process, the Board of Control specifically requested the inclusion of restitution fines and restitution orders to the list of obligations that could be collected by the department. The act provides for the transfer from the department's collections an amount equal to the department's costs to administer the collection program to the General Fund to recover its expenditures.

Department staff is continuing to work with the counties/courts and state agencies to overcome the obstacles to gaining full participation. Currently, eight counties/courts are participating; 12 are scheduled for participation the remainder of this year; and four have actively expressed an interest in participating. In addition, for most of those participating, there has been a noticeable increase in the number of court-ordered debts referred to and collected by the department. For the 18-month period following implementation of AB 3343 (January 1, 1995, through June 30, 1996), seven counties/courts submitted approximately 44,000 accounts for collection and the department collected $716,000. For the seven-month period beginning July 1, 1996, through January 31, 1997, approximately 57,000 accounts were submitted to the department for collection and the department has collected $1.8 million.
SB 580 was enacted last year (Stats. 96, Ch. 705) to implement a collection program for restitution orders due victims. The Department of Corrections is authorized to contract with a private collection agency or the department for collection of these orders from parolees. The act requires the Department of

Corrections to develop an implementation plan to collect victim restitution orders on behalf of the victim from parolees.

SPECIFIC FINDINGS

Under current law, the department is authorized to collect "fines, state or local penalties, forfeitures, restitution fines, or restitution orders" that are only due a county or the state. The department is not authorized to collect the variety of fees, costs or assessments that are added by the government and court imposed. Under current practice, many counties/court systems cannot separate (unbundle) these added amounts from the court-ordered fines, penalties, forfeitures or restitution fines/orders. Because they cannot unbundle the debts, the county/courts cannot refer the court-ordered portion of the debt to the department for collection.

This provision would allow the state or counties to refer to the department for collection court-ordered fees, assessments and other amounts, in addition to "fines, state or local penalties, forfeitures, restitution fines, or restitution orders."

Currently, the department is not precluded from entering into interagency agreements/contracts to perform services for other state agencies, including collection services. However, the department would need specific authority to collect the debt as though it were a delinquent personal income tax or on behalf of an individual, which would include any debts that may be subject to referral to the department under Department of Corrections' SB 580 implementation plan.

Under this provision, the Department of Corrections or any other governmental entity authorized to collect on behalf of the victim could refer restitution orders due an individual to the department for collection, but only if the authorized governmental entity voluntarily agrees to other administrative duties relating to account referrals and collection distributions.

Under current law, there are two Articles 6 in Chapter 5 of the AFITL, each with different subjects: "Collections of Amounts Due a Court" (commencing with Section 19280) and "Collections for the Department of Industrial Relations" (commencing with Section 19290). In addition, there are two Sections 19532, each with different subject: one section provides for fees for Tax News and Package X, and the other provides for the collection hierarchy, in the event multiple debts, including court-ordered debts, are being collected by the department.

Under this provision, the article relating to court-ordered debts would be renumbered Article 5.5 and the section providing the collection hierarchy would be renumbered 19533.

Policy Considerations

An offender is required to pay the costs associated with the offense, trial and conviction to reimburse government and society for the costs attributable to the criminal offense. If collection of the obligation is not enforced, the requirement serves little purpose. This provision would aid in the collection of these obligations.

The intent of the collection program is to increase funding for the State Restitution Fund. This provision would reduce the counties' participation obstacles and help to accurately measure the successes and failures of this

collection program by subjecting all funding sources for the state Restitution Fund to collection.

5. CHANGE IN DOING BUSINESS DEFINITION

EFFECTIVE DATE

This provision would apply to income years beginning on or after January 1, 1997.

PROGRAM HISTORY/BACKGROUND

The department historically has taken the position that corporate partners of a partnership are "doing business" in California if the partnership is doing business. This applies to general partners, as well as limited partners and members of a limited liability company (LLC). A substantial number of corporate partners have complied with this position.

The Board of Equalization (BOE) recently held, in Appeal of Amman & Schmid Finanz AG, et.al., that a corporate limited partner in a tiered partnership structure in which the bottom tier limited partnership was doing business in California was not itself doing business and was therefore not subject to the minimum franchise tax. In this case, the corporate limited partners were liable for the California income tax; however, the amount of income tax liability was less than the $800 minimum tax liability. The BOE decision did not address the applicability of the franchise tax if the corporate partner had been a general partner in a tiered partnership or a member of an LLC.

SPECIFIC FINDINGS

Existing state law imposes a franchise tax on corporations for the privilege of exercising their corporate franchise in this state. This tax is imposed on corporations that are incorporated, qualified to do business, or "doing business" in California. "Doing business" is a term that is defined in R&TC Section 23101 as: "actively engaging in any transaction for the purpose of financial or pecuniary gain or profit."

Existing state law also imposes a minimum franchise tax of $800 on every bank or corporation that is liable for the franchise tax. This tax may be $600 if certain criteria are met by a new business in its first year.

Existing state law imposes an income tax on taxpayers that derive income from California sources, but are not "doing business" within the limits of this state. The fundamental differences between the franchise tax and income tax are (1) interest on federal and state securities are included in the measure of income for purposes of the franchise tax but exempt from the income tax and (2) banks are excluded from entities subject to the income tax.

Existing state law also imposes specific taxes on other business entities. Limited liability companies treated as partnerships for California tax purposes are required to pay an annual LLC tax of $800 and an annual fee based on total income reportable to California. Limited partnerships and limited liability partnerships also are liable for an $800 tax.

This provision specifically would include in the definition of doing business the holding of a tiered partnership interest in a partnership that is doing business in

this state. However, it would exempt the corporate partner from the minimum franchise tax.

Policy Considerations

In the Amman case, a corporate limited partner that was not itself physically present in California was held not to be liable for the California minimum franchise tax even though the limited partnership in which it held an interest was "doing business" in California. That decision effectively permits an out-of-state corporation to indirectly (through a limited partnership) operate in California without being subject to the franchise tax. In-state businesses are potentially disadvantaged by this decision since their direct in-state activities subject them to the franchise tax while the out-of-state corporation avoids the franchise tax.

This provision would eliminate the possibility that taxpayers whose presence in California is through a tiered arrangement would be treated significantly different than taxpayers with a direct presence in this state. In recognition of the BOE decision, this provision would not subject taxpayers in the circumstances of the Amman case, and similar cases, to the minimum tax. However, these taxpayers would be subject to the franchise tax rather than the income tax. This provision recognizes that in tiered, pass-through entity structures with a single source of income, the lowest tier partnership, can trigger multiple impositions of the minimum tax.

This provision would eliminate the possibility that the Amman decision could be used to structure business relations in a manner that creates a competitive disadvantage to local businesses vis-à-vis out-of-state businesses, while still respecting the decision reached in that case.

TAX REVENUE DISCUSSION

The placement of corporate limited partners under the franchise tax rather than the income tax as a result of this provision's response to Amman effectively would make interest income on government obligations (state or federal) includible in the tax base of corporate limited partners. No basis currently exists to quantify the potential revenue gain from this provision.

The potential revenue loss from the $800 minimum tax no longer applying to certain corporate partners also is unknown. On balance, the revenue impact would probably be minor revenue gains (i.e., revenue that would be gained from reported interest income would exceed current law payments of the $800 per entity tax).

6. CORPORATION DEFINITION TO INCLUDE BANKS

EFFECTIVE DATE

This provision retroactively would apply to the dates the affected code sections were originally enacted, except the changes made to Section 24411, which would apply to income years beginning on or after January 1, 1998. Also, the repeal of obsolete provisions of the bank tax rate would become operative on January 1, 1998.

BACKGROUND

California's Bank and Corporation Franchise Tax Act, enacted in 1929, imposed a franchise tax on every corporation and bank doing business within the limits of the state, unless specifically exempt. This act implemented the provisions of Section 16 of Article XIII of the California Constitution, enacted in 1928. This Constitutional provision authorized a state tax on banks according to or measured by net income in lieu of all other state and local taxes, except taxes on real property. This provision was adopted in response to federal legislation enacted in 1926 that authorized four forms of state taxation of national banks.

The corporation income tax, enacted in 1937, imposed a tax on the net income of every corporation from sources within California, other than income for any period for which the corporation is subject to the corporation franchise tax. This tax is imposed on every corporation, other than a bank. Because the constitution required that the tax on banks be in lieu of all other taxes and banks are subject to the corporate franchise tax, banks were excluded from the corporate income tax. This exclusion was effectuated by defining "corporation" in the B&CTL as every corporation, except a bank.

In 1974, the California Constitution was amended to authorize the taxation of corporations, including state and national banks, and their franchises by any method not prohibited by the California or U.S. Constitutions.

SPECIFIC FINDINGS

Under existing federal law, the Internal Revenue Code (IRC) includes banks in the definition of "corporation."

Existing state law, under the **Constitution**, includes banks in the meaning of the term "corporation."

Existing state law, under the **Corporations Code**, includes banks in the meaning of "corporation."

Existing state law, under the **Financial Code**, defines "bank" as any incorporated banking institution that was incorporated to engage in commercial banking business or trust business. This definition further provides that soliciting, receiving, or accepting of money or its equivalent on deposit as a regular business is deemed as commercial banking business. Also, this section provides that it is unlawful for any corporation, partnership, firm, or individual to engage in or transact a banking business in this state except by means of a corporation duly organized for that banking purpose.

Existing state R&TC, defines "corporation" as follows:

1. Under the B&CTL, "corporation" is defined as every corporation except banks. Conversely, the B&CTL (Section 23051.5(h)(8)) provides that "corporation" includes banks when applying provisions of federal law to which the B&CTL is conformed.
2. Under the Personal Income Tax Law (PITL), "corporation" is defined as including joint-stock companies or associations, insurance companies, business trusts, and trusts organized and operated as charitable organizations. This definition does not expressly exclude banks.
3. Under the AFITL, "corporation" is defined by reference to the PITL or the B&CTL for provisions applied in connection with those laws.

Under current practice, when a statute is enacted that uses only the term "corporation," the department generally applies it to both banks and other

corporations unless the context of the statute and the legislative intent behind its enactment indicate its application only to nonbanking corporations.

Under current practice, the department administers Section 24411 as follows: in a water's-edge context, a foreign corporation can pay exempt dividends to a domestic water's-edge taxpayer, but a foreign bank cannot. Thus, the payor of exempt dividends cannot be a bank, but the recipient can be because both banks and other corporations qualify for water's-edge tax treatment. **Upon review**, it appears the administrative policy to exclude banks from the application of Section 24411 may have been based solely on the statutory use of the term "corporation" rather than a conscious legislative policy decision. Indeed, Franchise Tax Board Regulation 24411 provides that more than 50% of the payor corporation's total combined voting power of all classes of stock entitled to vote must have been owned directly or indirectly during the base period by a bank or corporation that is a member of the current year's water's-edge group. Thus, a bank can own a payor corporation, but a bank cannot be a payor corporation.

This provision would:

1. modify the definition of "corporation" to include banks, unless specifically provided otherwise;
2. provide specific language to exempt banks from existing provisions of the AFITL and the B&CTL for which intentional differences between the treatment of corporations and banks is clear, such as the corporation income tax;
3. replace the phrase "bank or corporation" with the term "corporation" throughout the B&CTL and the AFITL. The department's policy of not allowing Section 24411 to be applicable to banks would be reversed.

This provision also would repeal language regarding the calculation of the bank tax rate that has been made obsolete by the statute that set the bank tax rate at the franchise tax rate plus 2% for income years ending on or after December 31, 1995. This provision also would repeal the code sections that relate to the bank tax rate calculation and were made obsolete by the enactment of the 2% rate.

Policy Considerations

This provision would mitigate ambiguities caused by the unique definition of "corporation" contained in the B&CTL by standardizing that definition while also providing statutory language for the application to banks of those provisions intended to apply to banks.

This provision would clean up the B&CTL and AFITL by (1) amending the definition of "corporation" to include banks, (2) removing all references to "bank" throughout the law except where differences between the treatment of banks and other corporations are intended, and (3) adding language to except banks from provisions that currently use only the term "corporation" and do not and should not apply to banks. Making these corrections in existing law should eliminate similar drafting errors in future legislation.

Department staff involved with the water's-edge tax administration favor a policy of treating banks and other corporations the same in this context. However, a change in the current administration of Section 24411 would result in a revenue loss.

TAX REVENUE DISCUSSION

Revenue losses would occur to the extent California waters'-edge filers are able to deduct foreign dividend payments from foreign financial subsidiaries (not branches). While specific dividend-payment data for these taxpayers are not available, revenue losses are not expected to be particularly significant for the following reasons:

- Most California-domiciled banks do not file on a waters'-edge basis.
- Of those that do file on a water's-edge basis, most have foreign branches rather than subsidiaries (branches are included on the return and intercompany dividends are eliminated).
- Corporations that are owned by foreign banks do not typically receive dividend payments from the parent corporation.
- Non-California banks that do business in California have comparatively low apportionment factors for assigning income to California.

To establish an order of magnitude estimate for this provision, it is projected that annual revenue losses most likely would not exceed $1 to 2 million, which amounts to less than 5% of the current law impact for foreign dividend deductions.

7. REMOVE CREDIT ELECTION

EFFECTIVE DATE

Specified language in this bill would apply these provisions retroactively to the date the credits were enacted.

BACKGROUND

Elections In General

Taxpayers are faced with a variety of choices in determining the amount of their tax. Some choices are made in the form of an election; including, expense deductions, S corporation status, tax credits, accounting periods, accounting methods, and capital gains and losses.

The time and manner for making various elections are set forth in statute, regulations, tax forms and instructions, and case law. Generally, elections must be made by the due date (including extensions of time) of the tax return for the first year for which the election is effective. Although returns can generally be amended at any time within four years from the time prescribed by law for filing the original return, some elections are irrevocable and for some the department has the statutory discretion to accept or deny an amended return that makes, changes or revokes the election. The department follows the judicially created "doctrine of election" and seven factors developed by the IRS to determine whether to grant a request to make or revoke an election.

The "doctrine of election" was established by the U.S. Supreme Court for elections required under the IRC and subsequently was cited with approval by the Board of Equalization for elections required under the California R&TC. This doctrine prohibits a taxpayer that makes an election required in the tax code

from revoking that election. The purpose of the doctrine is to prevent retroactive tax planning and an undue burden on the administration of tax laws. The federal courts recognize several narrow exceptions to the doctrine (e.g., mistake of fact, impermissible reporting or errors).

The seven factors developed by the IRS to determine whether to grant a request to revoke an election are whether: (1) the statute of limitations for the year is still open, (2) the revocation is not requested for the purpose of income tax avoidance, (3) the initial election was not the result of a conscious choice, (4) the interests of the government will not be prejudiced by the revocation, (5) the taxpayer will not have a lower tax liability in the aggregate for all the years affected, (6) the revocation will not result in the utilization of expiring net operating losses or credit carryovers, and (7) the taxpayer acted reasonably and in good faith. The IRS employs one or more of these factors depending on the facts and circumstances of the case.

Election Provisions To Limit Credits

Designation of boundaries for the LARZ resulted in the first overlap of incentive zone boundaries. Portions of the LARZ overlap an enterprise zone or a program area. Because these overlaps would have made it possible for taxpayers to qualify for more than one zone credit for the same item of property, the Legislature included an election provision in the LARZ sales or use tax credit requiring the taxpayer to elect a single credit for that property. The fact that an item of property might qualify for credits other than zone credits, such as the recycling equipment credit, was not discussed in the legislative committees. The LAMBRA sales or use tax credit and hiring credit, enacted after the LARZ tax credits, have an election provision. An election provision is also in the enhanced oil recovery credit enacted by SB 38 (Stats. 1996, Ch. 954).

SPECIFIC FINDINGS

Current state law provides a sales or use tax credit, a hiring credit and a construction hiring credit for taxpayers conducting business activities within the LARZ and a sales or use tax credit and a hiring credit for taxpayers conducting business activities within a LAMBRA. These credits are equal to a specified percentage of the cost of qualified property or wages paid or incurred with respect to certain employees.

Except for the LARZ hiring credit and LARZ construction hiring credit[2], these credit provisions require the taxpayer to make an election, on the original return[3], choosing one credit if the expenditure for the property or employee's wages qualifies the taxpayer for more than one credit (e.g., the property qualified for the LARZ sales or use tax credit, enterprise zone sales or use tax credit, and manufacturer's investment credit). This election must be made separately for each item of qualified property or each employee and can be revoked only upon consent of the department.

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[2] The LARZ hiring credit and construction hiring credit do not use an election to limit the taxpayer to a single credit for qualified costs. Instead, these credits require the taxpayer to reduce the amount of credit by any other hiring credit claimed for the same wages.

[3] The original wording of the election provision for LARZ required that the election be made "on the return filed for each year." The term "the return" for a particular taxable or income year has been interpreted by courts in the context of elections to mean the "original return." To avoid confusion, technical clean-up legislation enacted September 22, 1994, added the word "original" before the word "return."

This provision would remove the election provision from the LARZ sales or use tax credit, the LAMBRA sales or use tax credit and the LAMBRA hiring credit and replace it with a provision limiting the taxpayer to one credit with respect to qualified property or employees that qualify for the specified credits (i.e., LARZ or LAMBRA sales or use tax credit or LAMBRA hiring credit).

Policy Considerations

The intent of the election provision was to prohibit a taxpayer from claiming more than one credit for qualified costs. However, election provisions inherently have special rules and court interpretations that often go beyond that which the Legislature intended. For example, taxpayers must elect the desired credit on original returns and cannot claim them on amended returns. Unwary taxpayers lose all credits if none is claimed on the original return. This provision would remove the unnecessary election provision from tax credits while upholding the legislative policy of limiting taxpayers to one credit. This provision would benefit taxpayers by allowing them to claim a credit on an amended return.

OTHER AGENCY/INDUSTRY IMPACTED

The Trade and Commerce Agency and local zone coordinators are responsible for administering the zone programs. Any change in zone law may result in taxpayer questions that Agency staff and local zone coordinators must answer.

8. OPERATIVE DATE

EFFECTIVE DATE

This provision would become effective January 1, 1997, and apply to income years beginning on or after January 1, 1997.

SPECIFIC FINDINGS

Existing state law, under the B&CTL, defines “taxable year” as the year for which the tax is payable.

Existing state law, under the B&CTL, defines “income year” as the year that is the basis for the computation of net income.

Existing state law, under the PITL, defines “taxable year” as the year that is the basis for the computation of taxable income, as well as the year for which the tax is payable.

Existing SB 715, (department sponsored technical and clean-up changes) as enacted September 26, 1996 (Ch. 952), provides that the changes made by the provision apply only to taxable years beginning on and after January 1, 1997, unless otherwise provided. SB 715 contains both PITL and B&CTL provisions. The B&CTL provisions should apply to income years beginning on or after January 1, 1997, while PITL provisions apply to taxable years.

This provision would amend Chapter 952, which enacted SB 715, to reflect that its provisions apply to taxable or income years beginning on or after January 1, 1997.

Policy Considerations

This provision would ensure that the changes made by SB 715 are applied equally under the PITL and the B&CTL -- to the year that is the basis for the computation of income.

9. FINANCIAL CORPORATION OFFSET (TECHNICAL CLEAN-UP)

EFFECTIVE DATE

This provision would apply to income years beginning on or after January 1, 1997.

BACKGROUND

California's Bank and Corporation Tax Act, enacted in 1929, imposed a state tax on banks according to or measured by net income in lieu of all other state and local taxes, except on real property. The reason for the special "in lieu" tax rate for banks stems from restrictions imposed by the federal government on the right of the states to tax national banks.

Under California law prior to 1981, financial corporations (financials) were not allowed the same taxation treatment as banks and were subject to local taxes in addition to state taxes. Since financials were previously subject to local personal property or business license taxes, R&TC Section 23184 provided that financials could offset any amounts paid for these taxes against the franchise tax. However, AB 66 (Stats. 1979, Ch. 1150) eliminated the purpose of the offset provisions by granting financials the same treatment as banks with respect to local governments. It was determined that, since financials are considered to be in substantial competition with national banks, they should receive the same treatment. AB 66 also contained uncodified law specifically preempting local taxation of financials.

Some charter cities continued to assess personal property or license fees until the California Supreme Court, in 1991, ruled in the case of California Federal Savings and Loan Association V. City of Los Angeles, that charter cities could not impose personal property or business license taxes on financials that were subject to the in-lieu rate prescribed by R&TC Section 23182. The Court based its decision on the California Legislature's intent to preempt all cities, including charter cities, from assessing personal property or business license taxes by extending the in-lieu taxation to financials.

SPECIFIC FINDINGS

Under current **state law**, banks and financials generally are exempt from personal property tax and license fees imposed by any state or local government and are therefore required to pay an additional franchise tax rate in lieu of such taxes. For income years beginning on or after January 1, 1997, the in-lieu rate is 2% over the 8.84% corporate tax rate or 10.84%. Although current state law preempts the imposition of local personal property taxes or license fees, state statutes (R&TC) still contain outdated provisions that specify that if a financial paid such taxes or fees, the amount paid would be allowed as an offset against the franchise tax liability.

The outdated R&TC sections regarding offsets by financials are:

- Section 23184 that provides for an offset against the franchise tax for amounts paid to any state or local government by any financial;
- Section 23184.5 that describes litigation pending at the time of its enactment and the manner in which the department should treat offsets if courts upheld the constitutionality of such offsets;
- Section 23185 that requires each taxpayer claiming an offset to submit evidence supporting the claim;
- Section 23185a that requires a financial claiming an offset to pay tax, at the "in-lieu rate" provided by Section 23186, on the amount of the offset; and
- Section 23185b that requires that a taxpayer who has received a refund of personal property taxes and been allowed an offset of those taxes shall repay the amount of the offset in the year the offset was granted.

This provision would repeal the outdated B&CTL sections identified above and references to those sections in other sections.

Policy Considerations

This provision would make current law clearer by removing statutory provisions that conflict with recent court decisions and other R&TC provisions.

10. REFERENCE CORRECTION (TECHNICAL CHANGE)

EFFECTIVE DATE

This provision would become operative on January 1, 1997.

LEGISLATIVE HISTORY

SB 887 (Stats. 1995, Ch. 490).

BACKGROUND

Former R&TC Section 18634 required apportioning taxpayers whose total related group assets exceeded $200 million to file an information return once every three years, identifying the taxpayer's corporate parent and those affiliates directly or indirectly owned more than 20% by the parent corporation. This information return was required to be filed six months after the filing of a tax return. If the taxpayer willfully failed to comply substantially with the filing requirement, a $10,000 penalty could be assessed. The Franchise Tax Board voted to sponsor legislation to repeal this section since its requirements were essentially duplicative of R&TC Section 19141.6. This repeal was enacted in
SB 887 (Stats. 1995, Ch. 490).

SPECIFIC FINDINGS

Current R&TC Section 19141.6 requires all apportioning taxpayers to maintain certain information and provide it to the department upon request. If the taxpayer fails to provide the information, a penalty may be assessed. The penalty provision references Section 18634's requirement for an information return.

Since R&TC Section 18634 was repealed by SB 887, the reference in Section 19141.6 to Section 18634 is obsolete.

This provision would remove the obsolete reference to Section 18634.

Policy Considerations

Eliminating superfluous references aids the administration of the law by alleviating any potential confusion that may otherwise occur.

11. INTEREST ON OVERPAYMENT (TECHNICAL CHANGE)

EFFECTIVE DATE

This provision would become operative on January 1, 1998.

SPECIFIC FINDINGS

Existing state law Section 19301, enacted in 1951, provides that whenever a taxpayer overpays any liability, the department will credit the overpayment to any amount then due from the taxpayer and refund any remaining amount to the taxpayer.

Existing state law Section 19340, enacted in 1949, provides that the department will pay interest on any overpayment. If the overpayment is credited toward amounts then due from the taxpayer, the interest will be paid from the date of the overpayment to the due date of the amount against which the overpayment is credited. This section further provides that if an overpayment is credited against amounts due, interest allowed on the overpayment will first be credited against taxes due. If an overpayment is refunded to the taxpayer, interest allowed on the overpayment will be refunded to the taxpayer.

While an overpayment can be credited against any amount due, the law allowing interest on the overpayment does not make clear how interest will be treated once all taxes due have been paid. Section 19340 does not specifically state that after all taxes have been paid, any remaining interest to be paid on an overpayment will be credited against other amounts due and then refunded, if any interest remains.

In addition, Section 19301 provides that an overpayment can be credited against amounts due under Part 10 (PITL), Part 11 (B&CTL), or Part 10.2 (AFITL). Section 19340 refers only to the PITL and B&CTL. While taxes are due under the PITL and B&CTL, other types of amounts collected by the department, such as penalties and interest, are due under the AFITL.

This provision would change Section 19340 to reflect that when an overpayment is credited against any amount due, any interest on that overpayment also will be credited against any amount due.

This provision also would include a reference to “this part,” which is the AFITL.

Policy Considerations

Clarifying the law to eliminate inconsistencies and to reflect legislative changes (i.e., the addition of the AFITL) eases administration of the law by eliminating potential confusion.

12. REFERENCE CORRECTION (TECHNICAL CHANGE)

EFFECTIVE DATE

This provision is a technical correction and is reflective of current law.

SPECIFIC FINDINGS

The current California Business and Professions Code requires certain licensees to provide to the licensing board their federal employer identification numbers or social security numbers, pursuant to former R&TC Section 19276.

A similar requirement is contained in the California Insurance Code, which also references R&TC Section 19276.

Former R&TC Section 19276 has been renumbered as Section 19528, so the Business and Professions Code and Insurance Code references are incorrect.

This provision would amend the California Business and Professions Code and the California Insurance Code provisions to change the reference to the R&TC from Section 19276 to Section 19528.

Policy Considerations

Clarification of erroneous references makes the law easier to administer and reduces any potential confusion that may otherwise occur.

13. REDUNDANT REFERENCE (TECHNICAL CHANGE)

EFFECTIVE DATE

This provision is a technical correction and is reflective of current law.

SPECIFIC FINDINGS

In current law, R&TC Section 17220 prohibits deducting, for state personal income tax purposes, certain taxes that are either allowed for federal purposes or are imposed under the B&CTL.

These taxes are specifically listed in the statute as:

- state, local, and foreign income, war profits, and excess profits taxes;
- any tax imposed under Chapters 10.5, 10.6 or 10.7; and
- any tax imposed under Part 11 (commencing with Section 23001) or Section 23097.

Part 11 of the R&TC contains the tax law provisions that relate to banks and corporations, and the reference in the statute is all inclusive of those provisions. Section 23097, included in Part 11, relates to the tax imposed under the B&CTL on registered limited liability partnerships (LLPs) and foreign LLPs. The reference to tax imposed under Part 11 is all inclusive of the taxes imposed under the B&CTL, which includes Section 23097; thus, the reference to Section 23097 is redundant and unnecessary.

This provision would remove the reference to Section 23097.

Policy Considerations

Clarifying the law to eliminate redundancies eases administration of the law by eliminating potential confusion.